

# **Instructions for Schedule P (Form 1120-F) for the 2007 Tax Year**

## **List of Foreign Partner Interest in Partnerships**

### **General Instructions**

#### **Purpose of Schedule**

Schedule P (Form 1120-F) is in three parts. Part I is used to identify all partnership interests a foreign corporation directly owns that give rise to a distributive share of income effectively connected with a trade or business within the United States ("ECI") of the foreign corporation. In Part II, Schedule P is also required to reconcile the foreign corporation distributive share of effectively connected income and allocable expense with the total income and expenses reported to it on Schedule K-1 (Form 1065). In Part III, the corporation's outside basis in its directly held partnership interests that give rise to a distributive share of effectively connected income is apportioned between ECI and non-ECI under regulations section 1.884-1(d)(3) to determine the average value that is treated as a U.S. asset for interest expense allocation purposes under section 1.882-5.

#### **Who Must Complete Schedule P.**

A foreign corporation that is directly or indirectly engaged in trade or business within the United States, is required to file Schedule P (Form 1120-F) for all directly owned partnership interests that have effectively connected income included in the partnership's distributive share of income reported on Schedule K-1 (Form 1065). If the foreign corporation treats any of its distributive share of partnership income from a partnership that is not engaged in trade or business within the United States, as ECI with another trade or business of the corporation, the corporation's entire distributive share of the partnership K-1 income and expenses must be also be reconciled between ECI and non-ECI and reported on Schedule P.

A foreign corporation may be engaged in trade or business directly, or indirectly through the activities of one or more partnerships in which the corporation owns an interest. If a corporation owns an interest in a partnership that is directly, or indirectly engaged in trade or business within the United States through another directly or indirectly owned partnership interest, the corporation is also treated as engaged in trade or business as a result of the partnership's trade or business activities. See section 875(1). The foreign corporation's distributive share of income from a domestic partnership and certain foreign partnership interests is reported to the partner on Schedule K-1 (Form 1065). The distributive share of U.S. source income from an interest in a foreign partnership is also generally reported to the partner on Schedule K-1 (Form 8865). If the partnership has income effectively connected with a trade or business, the partnership is responsible to withhold quarterly estimated tax on the foreign partner's distributive share of estimated effectively connected income under section 1446 and report the amounts for the taxable year on Form 8805 (Foreign Partner's Information Statement of Section 1446 Withholding Tax). If a foreign corporation receives a Form 8805 from a partnership, it

must reconcile on Schedule P (Form 1120-F) its distributive share of income and expenses reported on Schedule K-1 (Form 1065) from such partnership.

### **Exceptions from filing Schedule P.**

A foreign corporation is not required to file Schedule P (Form 1120-F) if it is not engaged in trade or business within the United States or it files a protective tax return on Form 1120-F to declare that the corporation is not engaged in trade or business within the United States or that the corporation has no business profits attributable to a U.S. permanent establishment pursuant to an applicable income tax treaty. See the requirements of protective tax returns of foreign corporations under regulations section 1.882-4(a)(3)(vi). **Protective Election on Schedule P.** See instructions for line 20 below for making a protective partnership outside basis apportionment election with a protective return. Do not file Schedule P if the corporation does not have any ECI with respect to its combined distributive shares of income from all directly owned partnership interests.

### **When and Where To File**

Schedule P is attached to the foreign corporation's Form 1120-F and filed in accordance with the due date for filing the income tax return. See instructions to Form 1120-F for the time, place and manner for filing the foreign corporation's income tax return.

### **Other Forms and Schedules Related to Schedule P**

- **Form 1120-F, Section II.** Gross effectively connected income includible in the partner's distributive share is reportable on Form 1120F, Section II, in the applicable category of income. Expenses (other than interest expense) included in the distributive share that are apportioned to the partnership's ECI are also reported on Form 1120-F, Section II.
- **Schedule I (Form 1120-F).** Interest expense reportable on Schedule P is includible in the corporation's interest expense allocation computation under section 1.882-5. The corporation's distributive share of interest expense that is directly allocable to effectively connected income under regulations section 1.882-5(a)(1)(ii)(B) is reported on line 14b and on Schedule I, line 22. The corporation's distributive share of interest expense that is included in the taxpayer's three-step formula allocation is reported on line 14c and on Schedule I, line 9, column (b). The distributive share of the average liabilities for which the corporation also receives a distributive share of interest expense is reported in Part III of Schedule P on line 17 and on Schedule I, line 8, column (b). The corporation's distributive share of average liabilities reported on Schedule P and Schedule I does not include the liabilities of the partnership that give rise to directly allocable interest expense reported on Schedule P, line 14b. The average value of the partner's outside basis apportioned to ECI is reported on Schedule P, line 19 and as a U.S. asset on Schedule I, line 5, column (b).

- ***Schedule H (Form 1120-F), Part I, Part II and Part IV.*** The corporation's distributive share of non-interest expenses included on Schedule P, lines 4 and 5 are also included in the corporation's overall allocation and apportionment of expenses on Schedule H (Form 1120-F), Part IV, lines 39 through 42, if the partnership books constitute set(s) of books that are also reportable on Form 1120-F, Schedule L. If the partnership interest is not reported on Schedule L, the distributive share of partnership expenses allocable to the corporation's distributive share of ECI are included in Schedule H (Form 1120-F) in Parts I and Part II. See instructions to Schedule H (Form 1120-F).
- ***Schedule M-3 (Form 1120-F), Part II.*** The corporation's distributive share of partnership income may be reported in line 9 (domestic partnerships) and line 10 (foreign partnerships) in accordance with the corporation's reporting practices on its financial statements. See Schedule M-3 instructions, Part II, lines 9 and 10.

## **Part I - Section P List of Foreign Partner Interests in Partnerships**

In Part I, list the name, address and Employer Identification Number for each directly owned partnership interest that has effectively connected income included in the partner's distributive share reported on Schedule K-1 (Form 1065). Also include in the list of partnership interest in Part I, any interest in a partnership that is not engaged in trade or business within the United States, if the corporation treats some or all of its distributive share of income as ECI with another trade or business of its own within the United States.

**Do not report on Schedule P** any indirectly owned partnership interests (lower-tier partnership interests) that have income effectively connected with its own trade or business within the United States unless the corporation also owns a direct interest in the lower-tier partnership. The corporation's distributive share of ECI earned through lower-tier partnership interests is includable in the Schedule K-1 (Form 1065) reportable to the corporation by the partnership in which the corporation owns a direct interest, whether or not the directly owned partnership is itself engaged in trade or business within the United States.

Schedule P accommodates reporting for four directly owned partnership interests on the form. If the corporation directly owns more than four partnership interests required to be reported on Schedule P, attach a separate page or pages if needed to Schedule P and list the additional partnership interests in the same format as shown on the schedule. The reporting required in Parts II and III for each partnership must also be included for the additional partnerships listed in the attached page(s). Entities treated as partnerships for tax purposes include Limited Liability Companies (LLCs) that have not elected to be classified as a corporation and Limited Liability Partnerships (LLP's). Do not include any interest in a disregarded entity as described under regulations section 301-7701-2(c)(2).

## **Part II Foreign Partner Income & Expenses: Reconciliation to Schedule K-1 (Form 1065)**

Part II reconciles the partner's ECI and non-ECI to its Schedule K-1 (Form 1065) distributive share from each partnership listed in Part I. The Schedule K-1 lines are grouped for reconciliation of their income and expense in the following manner:

- *Schedule P Lines 1 through 5: ECI and non-ECI reconciliation of income and non-interest expenses from Schedule K-1 (Form 1065), lines 1 through 3.*
- *Schedule P Lines 6 through 9: Reconciliation of other income and other non-interest expenses from Schedule K-1 (Form 1065).*
- *Schedule P Lines 10 and 11: Total gross income and Total gross ECI from Schedule K-1 (Form 1065).*
- *Schedule P Lines 12 through 14: Reconciliation of total interest expense from Schedule K-1 (Form 1065).*

**Line 1.** Enter on Schedule P, Part II, line 1, the combined total income (loss) from Schedule K-1 (Form 1065) Part III line 1, Ordinary business income (loss), line 2 Net rental real estate income (loss) and line 3 Other net rental income (loss). Enter the combined amount in the Schedule P, Part II column to corresponding to column where the partnership is listed in Schedule P, Part I. The amount entered on line 1 is grouped into its gross income and gross expense components for allocation and apportionment to ECI and non-ECI under sections 864(c) and 882(c). The gross income apportionments are shown on line 3 and the allocation apportionments of expenses are determined under regulations section 1.861-8 and 1.861-8T(c) and reported on line 5.

**Lines 2 through 5. Gross income (loss).** Enter on line 2 the total gross income included in Schedule P, line 1. On line 3, enter the amount of ECI included in the gross income reported on line 2. If all of the gross income reported on line 2 is ECI, then report the same number on line 3. **Note:** Line 3 may exceed line 2 if losses included in line 2 are non-ECI and the income and gains are ECI. **Non-interest expense.** Enter on line 4 the total amount of non-interest expense included in line 1. On line 5, enter the amount of non-interest expense included on line 1 that is allocated and apportioned to ECI. Include on line 4 (and line 5 if applicable), guaranteed payments made by the partnership that are included in the combined net income (loss) reported on line 1. Interest expense included in line 1 is subject to allocation under section 1.882-5 and is reported in a separate grouping of all the corporation's distributive share of interest expense on Schedule P, line 12.

**Lines 6 through 9. Other Gross Income and Other Non-Interest Expense.** ***Other Gross Income.*** Enter on line 6, all other gross income from Schedule K-1 (Form 1065) that is not reported on lines 1 through 3. On line 7, enter the amount of gross income from line 6 that is allocated to ECI. **Note:** The amount on line 7 may exceed the amount on line 6, if losses included in line 6 are allocated to non-ECI and other gross income and gains are allocated to ECI. ***Other Non-Interest Expense.*** Enter on line 8, all other non-interest expense from Schedule K-1 (Form 1065) not reported on lines 4 and 5. On line 9, enter the amount of non-interest expense from line 8 that is allocated to ECI. Include on line 8 (and line 9 if applicable), guaranteed payments made by the partnership that are not included in lines 4 and 5.

**Lines 10 and 11. Summary of Gross Income.** Enter on line 10, the sum of the gross income amounts entered on line 2 and line 6. The amount on line 10 is the total gross income from Schedule K-1 (Form 1065). On line 11, enter the sum of amounts of ECI entered on lines 3 and 6. The amount on line 11 is the total gross ECI from Schedule K-1 (Form 1065).

**Lines 12 – 14. Interest Expense Reconciliation.** Enter on line 12, the amount of interest expense included in the net income (loss) reported on line 1. On line 13, enter the sum of the other interest expense reported on Schedule K-1 on line 13 and line 18. **Line 14 reconciliation.** Add lines 12 and 13 and enter the amount on line 14a. This amount is the corporation's total distributive share of interest expense from Schedule K-1 (Form 1065) that is subject to allocation under section 1.882-5. **Line 14b. Direct Interest Expense Allocation.** On line 14b, enter the amount of interest expense included in line 14a that is directly allocable to ECI under the regulation section 1.882-5(a)(1)(ii)(B) and the applicable requirements of section 1.861-10T(b) or section 1.861-10T(c). The amount included on line 14b is also entered on Schedule I (Form 1120-F) on line 22. **Line 14c. U.S. booked interest expense of the partnership.** Subtract line 14b from line 14a and enter the amount on line 14c. This amount constitutes the book interest expense of the partnership that is includible in the three-step formula under section 1.882-5(d) or 1.882-5(e). The amount on line 14c is also required to be reported on Schedule I (Form 1120-F) on line 9, column (b).

**Total Column.** For each line 1 through 14, combine the amounts in each column (include additional columns from additional pages attached to Schedule P to report the income and expense reconciliation to Schedule K-1 (Form 1065) of more than four partnerships) and enter the total in the Total column.

### **Part III - Foreign Partner's Average Outside Basis Under Regulations Sections 1.882-5(b) and 1.884-1(d)(3)**

Part III identifies the corporation's outside basis for each partnership interest identified in Part I of this Schedule P (1120-F) for purposes of determining the amount the corporation includes as a U.S. asset in Step 1 of the interest expense allocation under section 1.882-5. The outside basis is determined and adjusted under the rules applicable to the determination of the corporation's outside basis in the partnership for branch profits tax

purposes under section 1.884-1(d)(3), except that the amounts entered on lines 15 through 19 are the average values rather than the value as of the corporation's taxable year end or other determination date if applicable under the section 884 regulations. The average values are determined under the most frequent averaging period for which data is reasonably available. See section 1.882-5T(b)(3) and 1.882-5T(c)(2)(iv).

**Line 15. Section 705 Outside Basis.** Enter in the corresponding column on line 15, the corporation's average value of the outside basis (determined under section 705) of its interest in each partnership reported in Part I.

**Line 16. Partner Liabilities Included in the Corporation's Outside Basis.** The corporation's outside basis reported on line 15 is adjusted in line 16 to conform the corporation's distributive share of liabilities to the proportionate amount of its distributive share of interest expense. This adjustment is made only for purposes of determining the corporation's outside basis included in the interest expense allocation and branch profits tax computations. The adjustment is not made for purposes of determining the corporation's gain or loss from disposition of the partnership interest.

**Line 16a. Adjustment for directly allocable interest.** The outside basis must also be reduced by the average amount of any liabilities that give rise to directly allocable interest expense in accordance with the requirements of section 1.882-5(a)(1)(ii)(B). Enter the portion of the partnership liability subject to the direct interest expense allocation rules under section 1.861-10T(b) or (c) and which is subject to exclusion from the asset-based interest expense allocations. See section 1.861-10T(d). **Line 16b.** Enter the average amount of all other liabilities in the corporation's distributive share determined under section 752. **Line 16c.** Add lines 16a and b and enter the amount on line 16c. This amount is the corporation's combined average total distributive share of liabilities for the year. **Line 16d.** Subtract the amount on line 16c from line 15 and enter the amount on line 16d.

**Line 17.** Enter the corporation's average amount of liabilities or portion thereof, for the year for which the corporation receives a distributive share of interest expense for the year. See section 1.884-1(d)(3)(vi). Also, enter the amount of liabilities reported on line 17 on Schedule I, line 8, column (b).

**Line 18. Partner's Adjusted Average Outside Basis in Partnership.** Add lines 16d and 17 and enter the amount on line 18. The amount on reported on line 18 is the corporation's adjusted outside basis that is eligible for apportionment between ECI and non-ECI.

**Line 19. Partner's Outside Basis Allocable to ECI.** Enter the amount on line 19 of the corporation's average outside basis reported on line 18 that is apportioned to ECI. Also enter the amount on Schedule I (Form 1120-F), line 5, column (b). See regulations section 1.884-1(d)(3)(i) for the elective requirements for apportioning outside basis on mandatory proportionate income or asset method. For purposes of determining the proportion of the partnership interest that is a U.S. asset, a foreign corporation may elect separately for each partnership interest, to use either the asset method or the income

method described in regulations section 1.884-1(d)(3) (ii) and (iii). If the corporation does not timely elect either method in the first year the corporation has a distributive share of ECI from the partnership, the Director of Field Operations may make the elections on behalf of the corporation. See section 1.884-1(d)(3)(iv) and the instructions to line 20, below. **Note:** The required timely-filed election under section 1.884-1(d)(3) for apportioning outside basis between ECI and non-ECI also applies to lower-tier partnership interests that are not reportable on this Schedule P.

**Line 20. Outside Basis Election Method.** Enter the term “income” or “asset” on line 20, to indicate the elective outside basis apportionment method in determining the amount of ECI apportionment reported on line 19 of the corporation’s average value of its total adjusted outside basis of its partnership interest from line 18. The allocation method is subject to a five-year minimum period election that must be made in the first year the partner has a distributive share of ECI included in the income reported on Schedule K-1 (Form 1065). The elective method chosen must be used for both branch profits tax and interest expense allocation purposes during the same five-year minimum period.

**Asset method In general.** —A partner's interest in a partnership shall be treated as a U.S. asset in the same proportion that the sum of the partner's proportionate share of the adjusted bases of all partnership assets as of the determination date, bears to the sum of the partner's proportionate share of the adjusted bases of all partnership assets as of the determination date. The proportion of U.S. assets to total assets of the partnership is determined as if the partnership were a foreign corporation engaged in trade or business within the United States. Generally a partner's proportionate share of a partnership asset is the same as its proportionate share of all items of income, gain, loss, and deduction that may be generated by the asset.

**Income method.** —Under the income method, a partner's interest in a partnership shall be treated as a U.S. asset in the same proportion that its distributive share of partnership ECI for the partnership's taxable year that ends with or within the partner's taxable year bears to its distributive share of all partnership income for that taxable year.

**Protective election.** If the corporation files a protective tax return under section 1.882-4(a)(3)(vi), and the partnership is not engaged in trade or business within the United States, the corporation need not file Schedule P and report amounts with its Form 1120-F. However, if it is later determined that the corporation’s distributive share of partnership income is effectively connected with a trade or business of the corporation within the United States, the corporation will have failed to make a timely income method or asset method election with respect to such partnership outside basis apportionment. To preserve the right to allocate and apportion its outside basis under a chosen method, the corporation may make a protective election by filing Schedule P and completing Part I and line 20 with the protective return filing on Form 1120-F. The protective election is effective only for the first year in which the corporation’s distributive share is in fact ECI with a trade or business of the corporation within the United States. The corporation need not complete Part II or line Part III lines 15 through 19 with the protective election.